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TAGS: ECON EFIN EINV MY
SUBJECT: Malaysia's 2008 Budget: Pork Sold Separately

REF: KUALA LUMPUR 1429

KUALA LUMP 00001452 001.2 OF 003

¶1. Summary: On September 7, Prime Minister Abdullah Ahmad Badawi unveiled his 2008 budget proposal. Billed as a "fiscally responsible" budget, it projects a deficit of 3.1%, down from 3.2% in 2007. Although spending is up, the GOM projects higher GDP growth will generate more than adequate additional revenue flows to compensate for it. The Prime Minister (PM) also announced that he expects the private sector, including foreign investors, to help fund government-initiated development plans. While the budget contained some important new tax provisions including a welcomed decrease in corporate tax rates, simplified tax collection on dividends, and enactment of additional tax preferences for the Islamic financial sector, the most important tax reform measure, implementation of the new Goods and Services Tax (GST) proposed in 2004, was missing. In a panel discussion following the release of the budget, Ministry of Finance officials insisted it was still on the table. However, absent up-front support from the PM and with elections just around the corner, the GOM is unlikely to submit a GST proposal to Parliament in the coming year. This leaves the GOM without an answer to how it will reduce its dependence on revenues from the oil sector, even though depleting oil reserves imply this revenue stream will shrink in the near future. Absent tax broadening measures like the GST, the GOM, which currently gets 38 percent of its revenue from the national oil company, will find it increasingly difficult to maintain its fiscal deficit within manageable bounds over the next decade. End summary.

First, what the budget didn't do:

¶3. For an election year budget, many Malaysians were surprised by what it did not do. A widely anticipated voter-friendly cut in the top individual income tax bracket did not materialize, but neither did any additional "sin" taxes (on tobacco or alcohol) which the GOM tends to increase every year. Consistent with its billing as a "fiscally responsible" budget, no large new development projects were announced as part of the budget. However, the Prime Minister already had announced plans to invest heavily in three regions on the peninsula, including the "Iskandar Development Region" bordering Singapore, plus Northern and Eastern Corridor Regional Development Plans. Similar regional development projects are rumored to be in the works for East Malaysia as well. The Prime Minister announced that he is relying in large part on the private sector to finance these government initiatives.

Reducing the deficit? A closer look at the numbers:
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¶4. A closer look at the numbers shows that the GOM's formula for lowering the deficit is a result of two underlying assumptions, both of which have been received with some skepticism by local analysts. The first assumption is that real GDP will grow by 6 percent to 6.5% - a projection that analysts find somewhat optimistic. (Currently GDP is growing at approximately 5.7%.) The second assumption is that the private sector - particularly foreign investors - will provide the lion's share of the funding needed for the three regional development plans laid out by the Prime Minister.

Spending up 2.5% from last year

¶5. Total budget expenditures (operating and development) for 2008 are RM 168.8 billion ($ 48.2 billion) in 2008, up 2.5% from RM 164.7 billion ($ 47 .1 billion) in 2007.

Operating expenses up:

¶6. Operating costs will grow 4% to RM 128.8 billion ($ 36.8 billion) in 2008. Salaries comprise 28.1% ($ 10.3 billion) of operating expenditures and fixed charges and grants 49.6% ($ 18.3 billion).

$ 11.4 billion for development:

¶7. Gross development expenditure is budgeted at RM 40.0 billion ($ 11.4 billion), 2.1% lower than the revised allocation of RM 40.9 billion ($ 11.7 billion) in 2007 as the government intends to count on the private sector to drive economic growth. This 8% reduction

came as a surprise to many analysts, some of whom had projected an allocation of RM 48 to 50 billion ($13.7 to 14.3 billion) for 2008. However, the Ministry of Finance also may tap into its supplementary allocation of US$ 2.35 billion when the government does a mid-term review of the Ninth Malaysian Plan in mid-2008.

¶8. The biggest slice of the $ 11.4 billion development budget will go to education and training with $ 2.1 billion (18.4%), transport $ 1.9 billion (16.9%) and security $1.4 billion (15.2%). Trade & Industry and agriculture will receive $ 1.1 billion (9.7%) and $ 1.05 billion (9.4%) respectively.

Plans to cut subsidies?

¶9. Subsidies will constitute 7.9% ($ 2.9 billion) of operating expenditures, declining 15.8% from 9.8% ($ 3.5 billion) of operating expenditure in 2007, indicating the government will possibly reduce fuel subsidies (perhaps on gas) in 2008. Fuel subsidies are about three quarters of the total subsidy payment. So far, the government has kept its promise not to raise domestic fuel prices this year as crude oil prices continue to rise.

High oil prices to keep a lid on deficit, for now:
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¶10. Despite the increase in public spending, the government announced that it expected the fiscal deficit to remain under control at RM 20.9 billion ($ 6.0 billion) or 3.1% of GDP in 2008, down from an estimated RM 19.9 billion ($ 5.7 billion) or 3.2% of GDP in 2007. The government projected revenue to increase 3.7% to RM 147.1 billion ($ 42 billion) in 2008 from RM 141.8 billion ($ 40.5 billion) in 2007, based on an assumption that oil prices will average $ 74 per barrel in 2007 and $ 75 per barrel in 2008. Oil-related revenues are expected to contribute $ 15.9 billion or 38% of total revenue in 2008, up marginally from $ 15.3 billion or

37.9% of total revenue in 2007. (Comment: As the petroleum income tax collection is based on preceding year's income, the government can be confident of its oil revenue in 2008. National oil company Petronas' dividend payment to the government will accelerate to $ 6.9 billion in 2007 from $ 5.1 billion in 2006.)

New tax provisions:

¶11. Following are the most significant changes to the tax code proposed in the 2008 budget:

-- Corporate tax, reduced from 28% in 2006 to 27% in 2007, will be reduced further to 26% in 2008 and 25% in 2009. This compares favorably to most countries in the region, with the exception of Singapore (18%) and Hong Kong (17.5%). Vietnam, China, Thailand, India, Indonesia and the Philippines all have higher corporate tax rates, ranging from 28% to 35%. (Taiwan's corporate tax rate is also 25%, but there is an additional 20% withholding tax on dividends.)

-- Tax on dividends will no longer be adjusted to meet the recipient's tax rate. Currently, taxpayers in brackets above the corporate rate are required to pay the difference; taxpayers in brackets below the corporate rate are eligible for a refund. (Dividend payments are not subject to double taxation in Malaysia.) Companies may opt for a six-year phase-in of this new provision.

-- Small and Medium-sized Enterprises (SMEs) will be exempt from filing monthly tax estimates and paying monthly installments for the first two years of operations. Tax for the full two years will be liable upon filing at the end of the two years. A SME is defined as a company with ordinary paid-up share capital of less than RM 2.5 million (US$ 727,000).

-- Information & Communication Technology (ICT) companies will be required to locate within specified geographic areas to retain current tax incentives. ICT companies will qualify for an exemption of import duties and sales tax for broadband equipment not produced in Malaysia.

-- Income derived from trading of Certified Emission Reduction (CER) certificates will be tax exempt.

-- Tax relief will be provided for post-graduate studies, sports

and exercise equipment, children's educational accounts, computers, broadband subscription fees, and some retirement benefits.

-- Expatriate income tax will be calculated according to the number of days physically present in Malaysia.

-- A 7% cap on deductions for approved charitable contributions will be extended to individual taxpayers as well as companies. (Currently only companies are subject to the cap.)

-- Companies located in the Labuan Offshore Financial Center can make an irrevocable election to be taxed at the regular Malaysian rate, allowing them to benefit from bilateral tax treaties that otherwise would exclude them.

-- Taxpayers will be permitted to make mortgage payments out of their retirement savings accounts.

-- A number of new incentives will be enacted for companies engaged in Islamic finance, including Islamic insurance (reftel).

Comment:

¶12. The issue the Prime Minister isn't bringing up for this election-year budget is the problem of declining oil revenues. Petronas provides 35 to 40% of the GOM's budget. However, Malaysia

is projected to be a net importer of oil within the next several years, based on a continued trajectory of 4% annual increases in domestic demand. This is a major problem because Petronas is obliged by the GOM to provide oil and gas for the domestic market at subsidized prices and it is responsible for covering the price gap between international and domestic prices. This of course eats away at its profits and its taxable income which is so essential to government revenue flows. While Petronas increasingly expands its operations overseas, it is unlikely to be able to do so rapidly enough to compensate for lost revenue when oil imports exceed exports. The problem of preventing a ballooning fiscal deficit when that happens is the elephant that everyone pretends not to see.

KEITH